Economic Bulletin
Senate Budget Committee - Majority Staff   Pete V. Domenici - Chairman

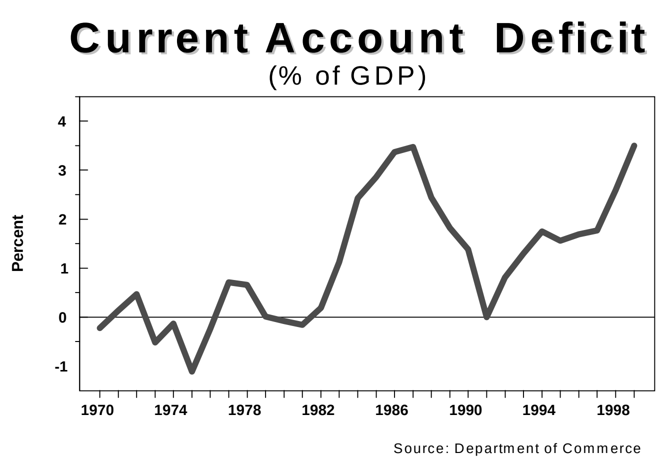
September 1999

US Overview: Economy Remains Strong, Imbalances Grow

The US economy continues to power ahead: retail sales are surging, industrial production is rebounding, the unemployment rate is at a 29 year low, while housing and auto sales have been surprisingly resilient in the face of higher long-term interest rates. While Hurricane Floyd may stunt employment and output measures in September, this should be a temporary phenomenon. Overall, growth should remain strong into year-end. While this is good news, some have also voiced concerns that the economy may be overheating.

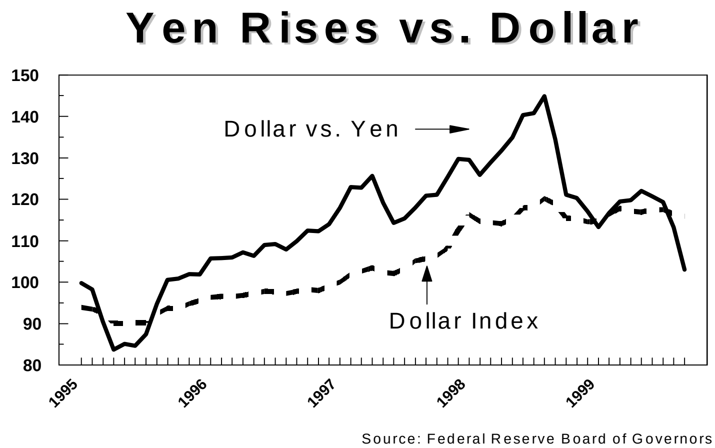
Signs of Economic Imbalance – the Trade Deficit

The economy has grown at roughly a 4 percent pace for the last three years, versus its assumed sustainable growth rate of 3 percent. This has prompted talk that the economy is overheating. Some dispute this conclusion, pointing to the low level of inflation. While contemporaneous inflation is low (more on this later in the Bulletin), other imbalances are apparent. Labor markets are remarkably tight, while the US trade deficit is surging.



Driven by buoyant consumer demand, the US current account deficit (the trade deficit plus interest service & transfers) will hit 3.5 percent of GDP this year, tying its 1987 record. A large current account deficit can signal that a country has become too reliant on foreign financing and that its currency is overvalued. At some point, foreign investors realize this and begin to worry that possible dollar depreciation could erase their returns on US assets. This prompts them to scale back their US investments, which triggers the very dollar collapse that they initially feared.

Some commentators have begun to worry that the dollar's fall against the Japanese yen indicates that this process has already begun in the US. At present, this view may be overly pessimistic -- the dollar index (a weighted measure of the dollar's strength versus the currencies of its major trading partners) has remained relatively stable throughout 1999, suggesting that the dollar's fall versus the yen is due more to a change in sentiment about Japan's economy, rather than the US economy.



However, if the US current account deficit continues to grow and the dollar keeps sliding against the yen, this could prompt a generalized weakening of confidence in the US, which could lead to a broader fall in the dollar and US asset markets. Since the rising stock market has been a key force behind recent US growth, an equity correction could lead to an undesirably sharp economic slowdown.

The current account deficit should ease somewhat as the global recovery gains steam and demand for US exports increases. However, in order to have an appreciable improvement, most believe that US consumption will need to slow. Thus, the key question the Fed faces is whether consumption will slow gradually on its own, or whether it needs to raise interest rates to achieve this goal.

Will the Fed Tighten in October?

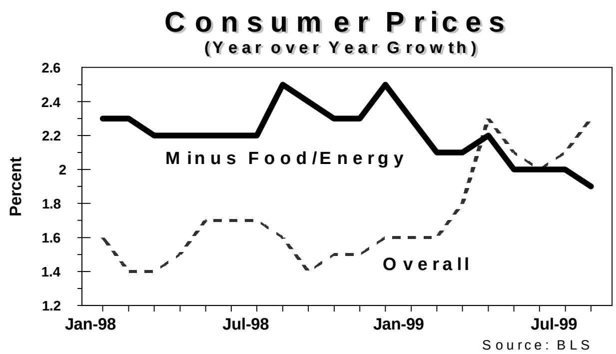
Barring a substantial and sustained stock market correction, many economists believe the Fed will raise rates in coming months to correct current overheating. Yet, the timing is uncertain due to Y2K. On the surface, it seems that Y2K shouldn't be an undue impediment to tightening. The Fed has said that most US firms appear to be Y2K compliant and that Americans' fear of Y2K is likely to be more problematic than events themselves.

The economic effects of Y2K are likely to be limited -- real GDP growth in the second half of 1999 may be boosted by several tenths of a percent as firms and households stock up in preparation for possible supply disruptions in the new year. Conversely, growth in the first half of 2000 may be pulled down by a similar amount as this (hopefully unnecessary) inventory is wound down.

Nonetheless, while Y2K does not look too threatening, it is still hard to believe that the Federal Reserve will want to introduce any further uncertainty into the markets just before the turn of the century. No one really knows how the rest of the world will cope with Y2K and how this could affect global capital flows. Thus while a tightening is still possible at their October 5th meeting, the market consensus is that the Fed will only adopt a bias to tighten at this meeting, but will delay actual tightening until 2000.

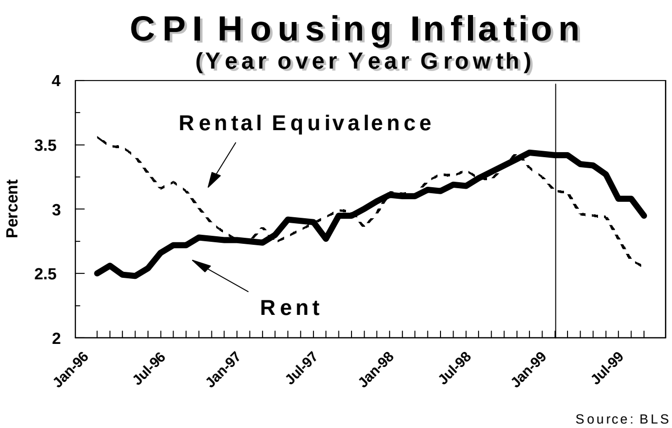
Selected Issue: The Anomaly of Core CPI

With the US economy showing some signs of overheating, it has been surprising that inflation has not picked up more rapidly. Certainly, headline CPI growth has risen due to the oil price increase. However, core CPI growth (which excludes the volatile food and energy sectors) has actually decelerated this year -- after ending 1998 at a 2.4 percent growth pace, core CPI is now running at only a 1.6 percent annualized rate for the first eight months of 1999.



What could account for this easing core of CPI inflation? Last year's low oil prices may be having some lagged pass-through effects on the core. In addition, 1999 annualized growth suffers from smaller tobacco distortions than end 1998's growth rate. However, there is another factor which gets less attention -- technical CPI changes by the Bureau of Labor Statistics (BLS).

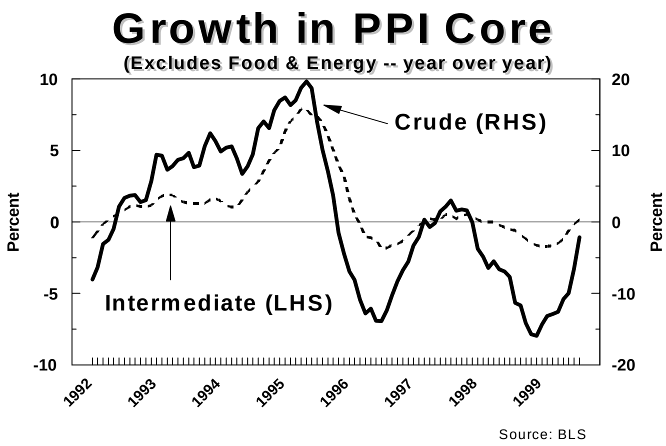
As part of its ongoing efforts to enhance CPI's accuracy, BLS introduced two changes in January 1999: 1) it altered its method for accounting for consumer substitution within CPI categories and 2) it changed its rent survey and method for calculating owners' equivalent rent (the amount a home-owner would theoretically have to pay to rent his house). BLS expects the former change to shave 0.2 percent from headline CPI growth and slightly less from core CPI growth. BLS does not believe that its housing survey changes affect CPI growth. On net, this suggests that technical changes have played only a small role in restraining 1999 core CPI growth relative to 1998.



Yet, some observers disagree. They believe the housing changes have impacted CPI, pointing to the notable deceleration in the rent and rental equivalence measures in 1999, even as rental markets have tightened in many places. Since these rental measures account for 35 percent of core CPI, even a small change would have a large impact. If rent and rental equivalence had continued to rise at last year's pace, core CPI growth would be 0.3 percentage points higher this year. Thus, these observers believe technical changes overall may have cut 0.4 percentage points from core CPI growth this year alone.

It is hard to know if technical housing changes are behind some of the deceleration in core CPI or not. Since BLS did not believe that these housing changes would affect CPI growth, they did not include them in their CPI-U-RS (a research CPI series which adjusts historical data to reflect technical CPI changes). Furthermore, BLS no longer collects some of the data used in its old calculations, so there is no way to construct an overlap series.

These uncertainties do suggest some caution in reading too much into the deceleration in core CPI growth. However, even if one supposes that current inflation is genuinely contained, this would still not refute the idea that the economy is overheating. It takes time for price pressures to become ingrained, particularly when they have been low for such a long period. As such, it is interesting to look to see if there are any signs of "pipeline" price pressures, which could point to generalized inflationary pressures down the road.



Some pipeline pressures are visible. Growth in core producer prices at the crude and intermediate goods levels has picked up. While still negative, the trend has worried some economists. Although competitive pressures could prevent part of these pipeline pressures from surfacing at the final stage of PPI or CPI, some pass through seems likely. Given the lags between monetary changes and actual impact on the economy, the Fed acts based on its outlook for future inflation. Thus the existence of low core CPI growth today would not preclude a Fed tightening in coming months if it sees broader inflation threats in the pipeline.

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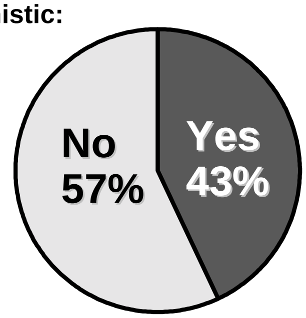
Main US Economic Indicators:

	Q4-98	Q1-99	Q2-99	Most Recent
Real GDP Growth	6.0	4.3	1.8	NA
Trade Deficit ($bn)	43	54	65	25.2 (Jul)
Unemployment Rate	4.4	4.3	4.3	4.2 (Aug)
Productivity Growth	4.2	3.7	0.7	NA
CPI Inflation	1.6	1.7	2.1	2.3 (Aug)
30 Yr Treasury Yield	5.2	5.6	6.1	6.1(Sept)
Dow Level	9,200	9,800	11,000	10,300(Sept)

In September, Blue Chip asked its economists if 30-year Treasury yields had peaked for the year. Most were pessimistic:



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